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ABSTRACT

An Internal Revenue Code provision (section 127) that allows taxpayers to exclude from gross income the amounts their employer paid for their education expired at the end of 1987. Several bills have been introduced in the 100th Congress to reauthorize section 127. Without the exclusion, individuals may have to pay taxes on such assistance unless the education meets more stringent tests for an employee business expense deduction. The debate over whether the provision should be reauthorized involves issues of administrative burden, taxpayer equity, investment in human capital, and federal revenue loss. (Author/YLB)

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CRS REPORT FOR CONGRESS

EMPLOYER EDUCATION ASSISTANCE: A BRIEF DISCUSSION OF CURRENT LEGISLATION AND ISSUES

by
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March 11, 1988

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ABSTRACT

An Internal Revenue Code provision (section 127) allowing taxpayers to exclude from gross income amounts their employer paid for their education expired at the end of 1987. Without the exclusion, individuals may have to pay taxes on such assistance unless the education meets more stringent tests for an employee business expense deduction. The debate over whether the provision should be reauthorized involves issues of administrative burden, taxpayer equity, investment in human capital, and Federal revenue loss.

CONTENTS

ABSTRACT.....iii

INTRODUCTION.....1

BACKGROUND.....2
Employer Education Assistance.....2
Graduate Student Tuition Reductions.....5

EMPLOYEE BUSINESS EXPENSE DEDUCTION.....7

ISSUES.....9
Arguments for the Exclusion for Employer Education Assistance.....9
Arguments Against the Exclusion for Employer Education Assistance....11
Graduate Student Tuition Reduction.....14
Estimated Revenue Loss.....15

EMPLOYER EDUCATION ASSISTANCE: A BRIEF DISCUSSION OF CURRENT LEGISLATION AND ISSUES

INTRODUCTION

An Internal Revenue Code provision (section 127) providing tax advantages for what is known as employer education assistance expired at the end of 1987. The provision had allowed taxpayers to exclude up to $5,250 of payments that employers made for their education from their gross income in calculating their Federal income tax. Without this provision, such assistance can now generally be excluded only if the education meets more stringent tests for employee business expenses allowed under section 162. 1/

Several bills have been introduced in the 100th Congress to reauthorize section 127. A Senate bill, S. 39 (Senator Moynihan), would simply delete the provision of the law prior to 1988 stating that section 127 does not apply to tax years beginning after December 31, 1987. 2/ In doing so, it would permanently authorize not only the exclusion for employer education assistance but also a related but different exclusion, triggered by subsection 127(c)(8), for tuition reductions for graduate students employed by their school as teachers or researchers. Without the reauthorization of subsection 127(c)(8),

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1/ This report briefly summarizes the principal Internal Revenue Code provisions and Internal Revenue Service regulations with respect to employer education assistance. The report does not address all the tax questions that might arise about such assistance, nor are its conclusions necessarily applicable to particular circumstances.

2/ As of March 8, 1988, S. 39 had 34 cosponsors. A House bill, H.R. 123 (Representative Daub), is similar.

tuition reductions generally can be excluded from gross income (under provisions of section 117(d)) only for education below the graduate level.

A House bill, H.R. 1692 (Representative Guarini), not only would permanently extend section 127 (including subsection 127(c)(8)) but would make three additional changes as well. 3/ First, under previous law, the exclusion for employer education assistance was limited to $5,250 annually. Under the bill, this figure would be adjusted for inflation each year. Second, the annual limit for such assistance would not be applied to graduate students employed by their school as teachers or researchers. Third, tuition reductions for graduate students employed by their school as teachers or researchers would be excludable even if, contrary to current law, the reductions represent payment for services required to receive the reduction. 4/

BACKGROUND

Employer Education Assistance

Section 127 of the Internal Revenue Code previously allowed taxpayers to exclude from their gross income amounts paid or expenses incurred by their employer for educational assistance. The exclusion was first authorized through 1983 by the Revenue Act of 1978 (P.L. 95-600) and was subsequently

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3/ As of March 8, 1988, H.R. 1692 had 262 cosponsors.

4/ As initially passed by the House, H.R. 3545, the Omnibus Budget Reconciliation Act of 1987, provided that tuition reductions for such graduate students could be excluded even if they represented payment for services, beginning after December 31, 1986 (sec. 10302). However, this provision was deleted by the conference committee.

extended twice through the end of 1987. 5/ The exclusion, limited recently to $5,250 a year, applied to education provided either by the employer or by schools and other third parties. Any kind of education was covered other than sports, games, or hobbies, with some exceptions. 6/ Excluded assistance generally could be used for tuition, fees, books, supplies, and equipment, but not for meals, lodging, or transportation. The assistance had to have been provided under a written plan meeting tests generally applicable to employee benefit plans, and it could not discriminate in favor of highly compensated employees. 7/ Other provisions applied to self-employed individuals, principal shareholders and owners, etc.

Numerous employers offer assistance of some sort for education. A Bureau of Labor Statistics survey shows that in 1985 about three-quarters of all full-time employees in medium and large size firms were eligible for defrayment of education expenses. 8/ A U. S. Department of Education study likewise

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5/ Sec. 164(a). P.L. 98-611, signed on October 31, 1984, extended the exclusion until the end of 1985, while the sec. 1162(a)(1) of the Tax Reform Act of 1986 (P.L. 99-514), signed on October 22, 1986, extended it until the end of 1987. Note that both of these laws reauthorized the exclusion retroactively.

6/ According to Internal Revenue Service regulations, the term education "includes any form of instruction or training that improves or develops the capabilities of an individual." (1.127-2(c)(4) Education involving sports, games, or hobbies is covered if it involves the business of the employer or is required as part of a degree program. (1.127-2(c)(3)(iii))

7/ The Tax Reform Act of 1986 contained new nondiscrimination rules generally applying to employee benefit plans. According to the Conference Report on the legislation, the new rules were not applied to employee education assistance since sec. 127 was scheduled to expire before their effective date. "The conferees anticipate, however, that if educational assistance programs are extended to periods after the effective date of the new nondiscrimination rules, such nondiscrimination rules shall be applied." (Tax Reform Act of 1986. Conference Report, v. II, p. 508.)

8/ Employee Benefits in Medium and Large Firms, 1985. Bulletin 2262 (July 1986), p. 82. The survey included establishments with at least 100 or 250 employees, depending on the industry. Results of two other recent employer (continued...)

estimates that in 1984 employers helped pay for 14,800,000 courses taken by adults. 9/ Nonetheless, a significant number of people may not actually be able to obtain assistance. A study by the Rand Corporation shows that in 1983 under 40 percent of workers reported having had training while in their current job. 10/ Although some of the remaining workers may have declined offers of training, it is reasonable to assume that many had no opportunity to receive any, at least not through their employer. They may have worked for firms with programs limited to a small number of employees. 11/ They may have been

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8/ (...continued)
surveys are often cited. In 1985, the American Society of Training and Development (ASTD) surveyed 1000 public and private employers included in its membership. Of the 319 organizations that responded, ranging in size from 43 to more than 100,000 employees, 97 percent had educational assistance plans. (Employee Educational Assistance: Who Pays, Who Benefits. Alexandria, Virginia, 1985. p. 1.) ASTD members presumably are much more likely to provide education assistance than are other employers. A 1983 survey of the Fortune 1000 Companies found that nearly all of the 655 firms that responded had tuition reimbursement plans. (Joseph P. O'Neill. Corporate Tuition Aid Programs. Princeton, New Jersey: Conference of Small Private Colleges, 1984. p. 1.) For neither of the latter two surveys is it known what proportion of employers that did not respond provided educational assistance.

9/ Center for Education Statistics. Trends in Adult Education 1969-1984. Table C. The study was based upon data from the Current Population Survey, which is administered by the U.S. Bureau of the Census. Of the estimated 40,752,000 courses taken by adults (excluding full-time and some part-time college students), 14,800,000 (36 percent) were paid for, at least in part, and 11,342,000 (28 percent) were provided by employers. As the two categories of courses are not mutually exclusive, these numbers cannot be added together to determine the total number of courses for which there was employer assistance.

10/ Lillard, Lee A. and Hong W. Tan. Private Sector Training: Who Gets It and What Are Its Effects? Santa Monica: The Rand Corporation, 1986. p. 11. The estimate was based upon Current Population Survey data. Estimates based upon data from the National Longitudinal Surveys, administered by the U.S. Department of Labor between 1967 and 1981, were lower. p. 11-16. The term "training" as used in this report included educational instruction, though it apparently did not encompass all the education that might have qualified under section 127. It is not clear whether the term was restricted to training provided by or paid for by employers.

11/ A survey of 7,800 companies by the U.S. Chamber of Commerce shows that in 1985 employee education expenditures represented only 0.3 percent of
(continued...)

employed only temporarily or part-time or otherwise not been qualified for participation. 12/ Or, their firms may not have had programs.

Graduate Student Tuition Reductions

Subsection 127(c)(8) of the Internal Revenue Code previously allowed graduate students engaged in teaching or research activities for their school to exclude tuition reductions from their gross income. Exclusions for tuition reductions are generally authorized for employees of educational institutions under section 117(d), which has not expired, but which is restricted to education below the graduate level. 13/ Under section 117(d), education for which the exclusion applies may be for the employee or the employee's spouse and

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11/ (...continued)
payroll. (Employee Benefits 1985, p. 8.) As the companies were not selected randomly and only 13 percent responded, this estimate may not be representative of all employers.

12/ Lillard, Lee A. and Hong W. Tan. Private Sector Training: Who Gets It and What Are Its Effects? Santa Monica: The Rand Corporation, 1986. The Rand Corporation study found that women who participate intermittently in the labor force were significantly less likely to receive training. p. 17 The study also found that nonwhite males were also significantly less likely to receive it. p. 42

13/ Subsection 127(c)(8) did not itself authorize an exclusion for graduate student tuition reductions; rather, it provided that section 117(d) should be applied as if it did not have the restriction pertaining to graduate education. Subsection (c)(8) was added to section 127 by P.L. 98-611 (October 31, 1984), which extended the sec. 127 through 1985. When the Tax Reform Act of 1986 extended sec. 127 until the end of 1987, subsection (c)(8) was similarly extended. See footnote 5, above.

Prior to the enactment of P.L. 98-611, the Tax Reform Act of 1984 (part of the Deficit Reduction Act of 1984, P.L. 98-369) had for the first time included in the Internal Revenue Code a provision (sec. 117(d)) explicitly allowing an exclusion for tuition reductions. Previously, tuition reductions had been excludable through Internal Revenue Service regulation 1.117-3.

The Tax Reform Act of 1986 also contained a transition rule allowing exclusion of tuition reductions prior to July 1, 1988 for full-time graduate students if (1) the reduction would have been excluded under Internal Revenue Service regulations in effect on the date of enactment of the Tax Reform Act of 1984 (July 18, 1984) and (2) the student had been accepted for admission before July 1, 1984 and had begun study before June 30, 1985.

dependent children, among others; it can be provided either by the employee's institution or by other schools. Under subsection 127(c)(8), however, the education could only be for the graduate students themselves, and only if they taught or did research; it also had to be provided by their employing institution. Tuition reductions are excludable from gross income only if they do not represent payment for services required in order to receive the reductions. 14/ As was the case with employer education assistance, tuition reduction plans must be in writing and may not discriminate in favor of highly compensated employees.

Graduate student tuition reductions can be offered at any institution of higher education offering post-baccalaureate study, but they occur primarily at universities having a significant level of education leading to doctorate degrees. In the fall of 1983, the most recent year for which U.S. Department of Education data are available, there were 318,000 full-time and 274,000 part-time graduate students enrolled in such universities. About 30 percent of the students were enrolled in private institutions, which typically have higher tuition charges than public institutions. 15/ Data on how many of these students had tuition reductions could not be obtained.

14/ If the only compensation graduate students had received for teaching or research was reduced tuition, such reductions would have had to be included in their gross income. Section 117 does not allow an exclusion for what would otherwise be considered employment income. However, if the graduate students received tuition reductions in addition to "reasonable compensation" that was included in gross income (whether that compensation was paid in cash or as a tuition reduction), any additional amounts might be excludable. (Joint Committee on Taxation. General Explanation of the Tax Reform Act of 1986. p. 43.) Also see Internal Revenue Service Notice 87-31, p. 14. Prior to 1988, the free or reduced tuition that some graduate students received may have been provided under a sec. 127 employer education assistance plan rather than a sec. 117(d) tuition reduction.

15/ National Center for Education Statistics. Fall Enrollment in Colleges and Universities, 1983. p. 34-35.

EMPLOYEE BUSINESS EXPENSE DEDUCTION

With the section 127 exclusion no longer authorized, employees who receive educational assistance from their employer generally must include the amount of the assistance in their gross income when calculating their Federal income tax. Employers must generally increase withholding for the additional taxes employees owe. 16/ The assistance is also now subject to social security or railroad retirement taxes and to Federal unemployment taxes.

However, some employees might be able to exclude the amount of employer education assistance they receive as an business expense under section 162. 17/ To do so, their education must meet more stringent tests in Internal Revenue Service regulations about the relation of the education to

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16/ Some educational assistance provided by employers might qualify as a scholarship or fellowship and thus remain excludable under section 117(a). However, amounts paid as compensation for employment services (whether past, present, or future) or for studies that primarily benefit the employer would not qualify in this respect.

17/ If the amount of education assistance were equal to an employee's allowable business expense, the employee could exclude the assistance from gross income and the employer would not have to increase withholding. If the amount of education assistance were less than the allowable business expense, that amount would be included in gross income and then taken as a employee business expense deduction in calculating adjusted gross income. Such deductions may be taken by all taxpayers for purposes of determining their adjusted gross income. Unreimbursed allowable business expenses can be deducted from adjusted gross income only if the taxpayer itemizes deductions and only to the extent that the sum of such expenses and certain other miscellaneous deductions exceeds 2 percent of adjusted gross income. See the text discussion about unreimbursed business expenses on pages 11-12.

their employment. Under these tests, education is an allowable business expense if it either: 18/

(1) is required by your employer, or by law or regulations, to keep your salary, status, or job (if the requirements serve a business purpose of your employer), or

(2) maintains or improves skills required in your present work.

Even if these requirements are met, however, education is not an allowable business expense if it either:

(1) is required in order to meet the minimum educational requirements to qualify you in your trade or business, or

(2) is part of a course of study that will lead to qualifying you in a new trade or business, even if you did not intend to enter that trade or business.

For example, computer graphics specialists arguably could show that employer-reimbursed courses on new software programs would improve skills needed in their present work and not qualify them for a new trade or business. Their Federal income tax liability would not be changed due to the termination of section 127. On the other hand, mail room clerks presumably would have difficulty showing that the same courses were needed for their job or to improve their present work skills. They would likely have to include employer reimbursement for such courses in their gross income and, other things equal, pay taxes on it.

Graduate students no longer able to exclude tuition reductions through subsection 127(c)(8) would have difficulty claiming a deduction for such sums as employee business expenses. Presumably the courses they take either are needed to meet minimum requirements of a trade or business or would qualify

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18/ Internal Revenue Service. Your Federal Income Tax. (Publication 17) November 1987. p. 148. For more detail, see Internal Revenue Service regulations 1.162-5.

them for a new trade or business. Consequently, their tuition expenses would generally not meet the tests described above.

ISSUES

Employer education assistance and tuition reduction plans involve complex issues of education and tax policy that cannot be adequately addressed in a report of this length. The following discussion nonetheless summarizes some of the arguments that have been made about reauthorizing section 127.

Arguments for the Exclusion for Employer Education Assistance

In its report on the legislation that became the Revenue Act of 1978, which first authorized the exclusion for employer education assistance, the Senate Committee on Finance stated that the exclusion is needed to reduce administrative burdens on both employers and employees and also the Internal Revenue Service. According to the Committee, the test for deducting education costs as a business expense under section 162 often is ambiguous. As was shown previously for the course in computer software, computer graphics specialists presumably could deduct their allowable expenses while mail room clerks could not. But what about secretaries? Would knowledge of computer graphics improve job skills that are required, without preparing them for a new trade or business? Would their skills be "required" if they only produced but did not design reports? Could one course alone be considered "preparation" for a different kind of work? In many cases, these questions would be difficult to answer. Yet, if it is not clear whether education is job-related, the Committee argued, employers and employees have to justify their decisions about treating the expenses as business deductions. Employers have to decide whether social

security and unemployment taxes should be withheld. The Internal Revenue Service must use "valuable personnel time in making determinations of taxability." 19/

The Committee on Finance also argued that the exclusion for employer education assistance is needed for equity reasons. It noted that the business expense deduction cannot be used as much by entry-level employees, whose job requirements and skills generally are relatively narrow, as by higher-level employees, whose job requirements and skills frequently are broader. In the example discussed above, it would be easier for professional and managerial employees to show the relevance of a computer software course for their work than it would for secretaries and clerks. Moreover, although entry-level employees earn less than higher-level employees, they are more likely to have to pay taxes on the education assistance they receive since their education less frequently meets the tests of being job-related. The Committee maintained that requiring out-of-pocket tax payments (through increased withholding) from those least able to pay would discourage them from taking courses and act as a disincentive for upward mobility.

A third argument is that the exclusion for employer education assistance encourages needed investment in human capital. Further education, it is claimed, increases employees' productivity. They become more efficient in their current work and adapt more quickly to changes. As a consequence, there are increased returns to employers as well as higher pay for individual workers. The economy as a whole benefits. The President's Commission on Industrial Competitiveness, for instance, has argued that American workers must

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19/ Revenue Act of 1978. S. Rept. 95-1263, p. 100-101. For an extended analysis of the tests used to determine whether education is job-related, see Marcus Schoenfeld, The Educational Expense Deduction: The Need for a Rational Approach. Villanova Law Review, v. 27 (January 1982). p. 237-350.

be better prepared for employment if the Nation is to compete effectively. In the Commission's view, demographic changes and new technologies in the work force make it essential that people continue to learn throughout their lives. 20/ The Commission recommended that the Nation adopt various tax and education policies, including permanent authorization for section 127, in order to remove disincentives for workers to invest in their own training, reduce the reluctance of firms to provide training programs, and remove barriers to their cooperating effectively with schools. 21/

Arguments Against the Exclusion for Employer Education Assistance

One argument against reestablishing the exclusion for employer education assistance is that it would result in inequitable treatment for taxpayers who pay for job-related courses themselves. The exclusion obviously could benefit taxpayers only if they are employed by a company or organization that provides education assistance. Taxpayers who work for other employers or are unemployed would get no tax savings. 22/ Prior to 1987, the latter taxpayers could have claimed a deduction for payments they themselves made for job-related education, provided that it met the tests described above for allowable business expenses and that they itemized their deductions. However, the Tax Reform Act of 1986 restricted the use of deductions for unreimbursed employee business expenses by limiting the sum of them and certain other miscellaneous deductions

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20/ Global Competition: The New Reality, v. I, (1985), p. 32.

21/ Ibid., v. II, p. 147-150.

22/ While it is not known how many people work for employers who provide education assistance, the Rand Corporation study described above on page 4 suggests that a large proportion of the workforce, perhaps a majority, does not.

to amounts in excess of 2 percent of adjusted gross income. 23/ As a consequence, taxpayers who themselves pay for job-related education currently will realize only minimal tax savings, or frequently none at all. Yet, if the exclusion for employer education assistance were reauthorized, taxpayers whose employers paid for their education would get such savings, even if the education were not job-related.

Second, an exclusion from gross income such as is proposed for employer education assistance would result in a larger subsidy to taxpayers with higher incomes. Other things equal, the amount of tax savings from exclusions depend upon one's marginal tax bracket. In tax year 1988, for example, an exclusion of $1,000 would result in tax savings of $150 for people whose marginal tax bracket is 15 percent (for instance, married individuals filing joint returns having taxable income less than $29,750) but tax savings of $280 for people whose marginal tax bracket is 28 percent (married individuals filing joint returns having taxable income between $29,750 and $71,900). People with no taxable income, such as low-income wage earners with several dependents, might get no savings or subsidy at all. In contrast, Federal postsecondary student aid (Pell Grants, etc.) typically is greater, other things equal, for people with lower incomes. 24/

23/ P.L. 99-514, sec. 132. For example, a taxpayer with an adjusted gross income of $30,000 can deduct allowable unreimbursed employee business expenses (assuming he had no other qualifying miscellaneous expenses) only to the extent they exceed $600.

24/ Federal postsecondary student aid generally is based upon "need analysis" that reflects, among other things, expected financial contributions from the student's family. Other things equal, the higher the family income, the greater is the expected family contribution and the lower is the amount of student aid. The actual difference in tax savings for people of different income levels is likely to be greater than the example in the text suggests. According to the 1985 survey by the American Society for Training and Development, employees with salaries under $15,000 received an average of $400 of educational assistance, while employees with salaries of $50,000 or over

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Third, the human capital benefits of employer education assistance might not be as great as is claimed. While presumably most courses taken by employees receiving assistance either are job-related or provide basic educational skills, they are not the only type of courses for which the section 127 exclusion could have been taken. 25/ The statute did not require that the education be related to work, either current or future, or that it contribute to a career or lead to a degree. The only Federal restriction was that courses for sports, games, or hobbies generally were not covered. More important, some economists question whether education in general bears any substantial relationship to economic productivity. In their view, useful knowledge and skills by and large are learned on the job, not in school. While employees obviously must have some competency in reading and mathematics and some understanding of what is expected of them, further education, it is argued, is useful principally because it allows employers to select which job applicants to hire or which employees to promote in a socially acceptable way. Screening, not training, is its significance. From this perspective, employer education assistance might primarily subsidize personnel sorting, not useful development of human capital. 26/

24/ (...continued)
received an average of $1710. (Employee Educational Assistance: Who Pays, Who Benefits, p. 16.) If one arbitrarily assumes marginal tax rates of 15 percent and 28 percent, respectively, for these two groups, on the average the lower income employees would have received tax savings of $60 while the higher income employees would have received $479. A similar pattern may also exist with Federal postsecondary student aid, particularly the campus-based programs (College Work-Study, Supplemental Educational Opportunity Grants, and Perkins Loans) to the extent that students from families with higher incomes are more likely to attend higher-cost institutions.

25/ Ibid., p. 8.

26/ See for example Mark Blaug, Where Are We Now in the Economics of Education? Economics of Education Review, v. 4 (1985), p. 17-28.

Graduate Student Tuition Reduction

Should graduate students be able to exclude tuition reductions from their gross income? For many, the important issue is not whether reductions that do not represent payment for services should be excluded (which would be the only effect of reauthorizing subsection 127(c)(8)), but whether reductions that do so should be. One consideration is whether tuition reductions for which services are required should be seen essentially as employment income or as student financial aid. If they are viewed as employment income, an exclusion would not appear equitable with respect to other employed workers. Why should anyone receive tax-free pay just because they work for a university? On the other hand, if the reductions are viewed as student aid, an exclusion would appear equitable with respect to students who have fellowships of equivalent amounts. Why should some students pay taxes on part of the aid they receive, in addition to having to work for it, while other students neither pay taxes nor work for the same amount of assistance? 27/

A second consideration is whether the tax savings resulting from exclusion of tuition reductions would go to students who have the most financial need. While the tax savings resulting from a limited amount of teaching or research at public universities might be minimal, savings from extensive employment at private universities, where average tuition charges are several times higher, could be substantial. 28/ It would be useful to know how much other income is

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27/ Under the Tax Reform Act of 1986, scholarships and fellowships may be excluded from gross income generally to the extent that are used for tuition and fees and other course-related expenses (sec. 123).

28/ For example, exclusion of tuition reductions of $500 at public institutions would result in tax savings of $75, assuming that the students have marginal tax rates of 15 percent and that the reductions are not offset by the personal exemption or standard deduction. Exclusion of tuition reductions of $5,000 at private institutions would result in comparable tax savings of $750.

earned by students who receive the larger tuition reductions. It would also be useful to know how much income is earned by their spouse and whether they have dependents. If students are still dependent on their parents, what financial contributions might be expected of them? Even if universities award tuition reductions on the basis of merit, it would be helpful to know whether the tax savings resulting from the proposed exclusion would coincide with or conflict with the distribution of Federal need-based financial assistance.

Finally, it is important to place the issue of whether graduate student tuition reductions should be taxed in the context of changes made by the Tax Reform Act of 1986. Among other things, that legislation increased the personal exemption and standard deduction for students who are not claimed as exemptions on their parents' tax returns. 29/ By doing so, the Act effectively increased the amount of their income that is shielded from taxation. Whether additional income for such students should also be shielded is a question that needs careful study.

Estimated Revenue Loss

In the short run, whether section 127 is reauthorized may depend largely upon judgments about the revenue loss that would result. The Joint Committee on Taxation staff estimates that such loss would be $300 million for each of the first 3 years of an extension, and $400 million for a fourth. 30/ Supporters of reauthorization might view such losses as a good investment in

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29/ Sections 102-103. For a summary of provisions of the Act that affect education, see U.S. Library of Congress. Congressional Research Service. Provisions of the Tax Reform Act of 1986 Pertaining to Education. CRS Report for Congress No. 87-67 EPW, by Bob Lyke. Washington.

30/ Daily Tax Report, January 28, 1988, p. G1-G2.

the Nation's workers and economy. On the other hand, opponents of reauthorization might view them as only compounding Federal deficit problems.